

**The Federal Estate Tax: Using the Charitable Contribution as a Means of
Comprehensive Reform**

John Kerrigan
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Abstract

The purpose of this paper is to examine the current federal estate tax and suggest reform. However, this reform will be more than changing marginal rates and exempted estate amounts. This reform will come via turning the federal estate tax into a mechanism of charitable giving, rather than a source of revenue for the federal government. This will be accomplished through a series of brackets or threshold “steps” where an individual may donate a percentage of the estate to charity and decrease their federal tax liability. The paper begins with a brief history of the federal estate tax then follows with the proposal of allowing the entire estate to be bequeathed without any federal tax burden if a certain percentage of the estate is donated to a recognized charity. The paper then discusses support for the proposal through both the intent behind the federal estate tax and the preservation of the estate holder’s autonomy in determining how the money is spent. Finally, the paper acknowledges some of the counter arguments and criticisms that may arise from this proposal, and closes with a short conclusion on the feasibility of this proposal.

I. Introduction

The Federal Estate Tax is one of the most hotly contested sections of the United States Internal Revenue Code. The mere mention of reforming or revoking this tax brings battle cries from both major political parties, as the ongoing debate on how and if the tax should continue arises like clockwork. Some feel that the estate tax is an undue burden on the wealthy which often results in double taxation of assets, while others feel this tax is meant to be a powerful equalizer and necessary to keep the wealthiest 1% of Americans from holding too much power. Regardless of which position you take, the consensus amongst both sides is that the estate tax cannot continue in its current form. Proponents of the tax argue the tax has become meaningless as the exemption rates have climbed so high that only the wealthiest estates are affected, and that avoidance techniques are too favorable. Opponents argue that the tax has unfairly targeted the wealthiest of the wealthy and that the tax serves no purpose other than to punish them and appeal to the rest of society. Before we can discuss any type of reform, it is important to understand both the history and intent [both modern and historical] of the Federal Estate Tax as well as what assets of the estate are included and excluded from the tax liabilities.

a) History of the Estate Tax

The Federal Estate Tax has been around in the United States since the Civil War. It was originally referred to as the “legacy tax,” and was first levied as a tax on personal property [capped at 5%] before being modified to also include real estate [capped at 6%]. These taxes remained in place for eight years before being abolished, but were swiftly revived in 1894 to alleviate the stresses of the Financial

Panic of 1893 and were increased in 1898 to help pay the costs of the Spanish-American war.¹

During this same period, the first federal income tax was also simultaneously enacted as a supplement to the “legacy tax.” However, the income tax failed to gain public support and was declared unconstitutional by the Supreme Court in *Pollock v. Farmers Loan and Trust Co.* in 1895.² Without a federal income tax to help offset the costs of war, Congress then increased legacy tax rates until repealing them after the Spanish American War ended in 1902. Throughout the 19th Century, these taxes continued a cyclical trend of being enacted in times of financial need and then being repealed once the relevant crisis had subsided.³

The Federal Estate Tax in the form we know it today was not created until 1916 through the passage of the Emergency Revenue Act. This act both raised corporate tax rates and introduced taxes to estates over \$50,000 at a rate of 10%.⁴ The rates did not stay static for long, jumping first to 25%, then to 40%, then back to 20%, then to a top rate of 60% before finally settling at a top rate of 70% in 1935. While these percentages seem incredibly high, it is important to note that the 70% bracket did not apply until the value of the estate reached \$50 million [which is over

¹ David Joulfaian, Office of Tax Analysis, US Department of the Treasury, *The Federal Estate Tax: History, Law, and Economics* 2-1 (June 2013).

² *Id.* See, *Pollock v. Farmers Loan and Trust Co.*, 158 U.S. 601 (1895).

³ *Id.* at 2-2

⁴ Michael Graetz, Professor of Law Columbia Law School, Lloyd Leva Plaine Distinguished Lecture at the University of Miami Heckerling Institute on Estate Planning (January 11, 2011)(transcript available through the John M. Olin Center for Studies in Law, Economics, and Public Policy of Yale Law School). While not an academic paper, the transcript of this speech provides many factually and historically accurate depictions of the Federal Estate tax and the issues and controversies surrounding the major changes in its scope and administration since its enactment in 1916.

\$1 billion in 2013 dollars if adjusted for inflation].⁵ Much of the increases in the tax brackets can be attributed to the Great Depression as the Federal Government was faced with the problem of high expenditures for the economic recovery during a time of significant decreases in federal receipts due to the economic turmoil. Coupled with the United States being drawn into World War II, the money collected through the estate tax was vital for our successes overseas.

The Federal Estate Tax remained largely unchanged during the Second World War [with the exception of the top tax bracket being increased to 77%]. Reforms did not begin until 1948 with the passage of the spousal deduction [though this was originally this was limited to 50% of the estate]. Major reforms began in 1976 with the passage of the Tax Reform Act of 1976 (TRA76), which lowered the maximum taxable rates back to 70% and doubled the exempted estate size to \$120,666 with a special exemption for businesses and farms of up to \$500,000 for real property. TRA76 also included a generation skipping transfer tax (GST) that aimed to curb the practice of avoiding the estate tax by passing the estate down to younger heirs (grandchildren, great-grandchildren, etc.).⁶

Reform again came in 1981 and in 1986, which ultimately reduced the maximum rate to 50% and increased the exempted estate value to \$600,000. These reforms also touched the marital deduction exemption, and allowed for a full deduction of the estate for transfers to a spouse. Finally, the GST was again adjusted

⁵ Id.

⁶ Joulfaian, supra, at 2-4 -2-5.

to limit cumulative transfers of gifts to \$1 million per donor. In 1997 Congress again acted and increased the estate exemption to \$1 million.⁷

In 2001 President Bush and Congress enacted a temporary and controversial piece of legislation known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA sharply decreased the amounts collected from the estate tax throughout the decade [lowering the maximum to 45%], and ended with a complete repeal of the estate tax in 2010. The bill featured a sunset provision that would repeal EGTRRA in 2011 and bring the maximum rates back to their pre-2001 levels. Before that provision could take effect however, President Obama and Congress passed the Tax Relief Unemployment, Insurance Authorization, and Job Creation Act of 2010 (TRUIAJCA). Though this act did not extend the complete abolition of the federal estate tax, it significantly increased the total estate exemption [to \$5 million] and lowered the maximum rate to 35% through December 2012. The American Taxpayer Relief Act of 2012 (ATRA) solidified the temporary provisions of TRUIAJCA permanently, but increased the maximum tax rate to 40%.⁸

It is clear then from the passage of ATRA that the view of Congress and the current Administration is that the estate tax should only be applicable to the wealthiest of Americans. With this estate allowing a tax credit on estates of up to \$5 million, a significant portion of upper-middle class and upper class families will be able to avoid the federal estate tax while still passing on a large sum of money to their non-spousal heirs.

⁷ Id.

⁸ Id. at 2-5-2-6

b) What's Included in the Estate Tax Liability and Which estates are Liabile?

In our analysis for reform, it is imperative that we understand just what portions of the estate can potentially create a tax liability for the donor. First and foremost, the Internal Revenue Code defines an individual's gross estate as "being determined by...the value at the time of his death of all property, real or personal, tangible and intangible, wherever situated."⁹ This includes [but is not limited to] cash, real estate, securities, personal property, etc.¹⁰ ATRA solidifies that estates valued up to \$5.25 million are to be exempted from the federal estate tax as they will receive a federal tax credit, and any value of the estate beyond this is to be taxed at a flat 40% rate.¹¹ This already will exempt many estates, and with proper planning all but the largest estates will be subjected to any federal tax liability.

There are also significant allocable deductions that may minimize or eliminate a donor's tax liability should the value of the estate exceed \$5.25 million. These include the marital exemption, the charitable deduction, and to a lesser extent the gift tax. The marital exemption is the most straightforward of the three, and allows the estate holder to give 100% of their estate [regardless of value] to their spouse and escape any federal estate tax liability. This is by far the exemption of the estate tax that is most utilized, and often provides for anecdotal stories of elderly

⁹ 26 U.S.C §2031(a)

¹⁰ It is important to note that under the current regulation IRC §1014(a) any transfer of real property through a decedent's estate will result in the heir receiving a stepped up basis in the value of that property which is equivalent to the fair market value of the asset at the time of the donor's death. These types of property often have very large built in gains and the recipient is able to pocket the appreciation in value of the property from the time it was acquired without any tax consequences upon sale or dissolution. This is a highly contested area of federal estate tax law as many seek to increase the amount of money collected by abolishing the stepped up basis standard and replacing it with a carryover basis.

¹¹ 126 Stat. 2313 (2012).

wealthy individuals whose spouse has already died re-marrying someone much younger. The charitable deduction works in a similar way, and affords the donor an unlimited deduction for amounts of the estate donated to charitable organizations [again up to the full value of the estate].¹² Finally, the gift tax is meant to cover gifts made by the donor while they are still living. Currently the regulations allow gifts of up to \$14,000 per year per donee to be made, and allows for a lifetime gift of the estate of up to \$5.25 million should the gift exceed the annual amount.¹³ Through careful yearly gifts, an estate holder may be able to minimize any tax liability at death while still providing their heirs with a significant inheritance. Any one of these exemptions, or a combination of all three, may be used by the donor's estate to reduce their estate tax liability as much as possible.

\$5.25 million is no small amount, and many legal scholars are fascinated by the amount of negative publicity the estate tax generates, when it only applies to the wealthiest 1% of Americans. In his 2011 address to the John M. Olin Center for Studies in Law, Economics, and Public Policy at the University of Miami, Michael Graetz noted the monumental campaign that elite American families successfully mounted against the federal estate tax. He told a story of an individual named Pat Soldano, a financial planner and accountant as well as one of the biggest driving forces behind comprehensive estate tax reform in the late 1980's. Many famously wealthy American families were clients of Ms. Soldano, and they aggressively

¹² Joulfaian, *supra*, at 3-4-3-5.

¹³ 26 U.S.C. §2501. Through careful estate planning, an individual is able to leave large amounts of their estate to heirs and other individuals through this provision. Ideally the usage of this gift exemption will allow the estate holder to reduce the size of their estate to under the \$5.25 million threshold by the time of their death, so that the remaining estate will not qualify for any federal estate tax liability.

campaigned in Washington for preferential tax treatment, through multi-million dollar donations to powerful lobbying organizations and a spectacular publicity campaign. In order to make sure a majority of Americans would empathize with the situation, Ms. Soldano crafted a campaign to ensure that the “death tax” was viewed not just as problem for the ultra-wealthy but for small and medium sized family business owners as well.

Most politicians scoffed at this campaign, and assumed that the majority of Americans would never support a comprehensive reform of the estate tax. However, when California abolished their state inheritance tax in 1982 federal representatives began to take notice. Especially since the measure passed with over 64% of support, despite the tax only being paid by a tiny fraction of the state’s residents. These individuals started paying even more attention when they realized the millions of dollars being provided to lobbying organizations and political campaigns that were supportive of estate tax repeal. The movement began gaining public support throughout the late 1980’s and early 1990’s and the heavy publicity campaign spearheaded by Ms. Soldano came into its own in 1994.

This campaign centered around a Mr. Chester Thigpen, an 83-year old tree famer from rural Mississippi. In 1995 Mr. Thigpen testified before the House Ways and Means Committee about the consequences the current federal estate tax would have on his business, and the possibility of it forcing his children to sell off the farm after Mr. Thigpen’s death in order to pay the taxes due on the estate. Though Mr. Thigpen’s concerns were later proven to be a figment of his imagination [the estate he left behind was too small to be subjected to any federal estate tax] he became a

symbol for hardworking Americans who had spent their lives building successful family businesses and accumulated enviable nest eggs. The movement rapidly gained support through the end of the 20th century, and spurred the creation and passage of EGTRAA in 2001, which has framed the direction of the federal estate tax for the past decade.¹⁴

c) Reasons for Estate Tax Reform

The United States is facing an unprecedented fiscal crisis that is growing in both severity and size each day. The budget surplus of the 1990's under President Clinton has vanished, through a series of wars in the Middle East coupled with the 2008 Financial Crisis, and has been replaced by a heart-stopping national deficit of \$17 trillion. That averages out to \$54,000 per United States Citizen, or more importantly to \$150,000 per United States Taxpayer.¹⁵ With government spending on the rise, this number isn't going to be shirking anytime soon. A more recent example of this increased spending came from the controversial launch of the new federal healthcare website. Bipartisan estimates calculate that nearly \$200 million has been spent on the website's development, with congress allotting up to \$677 million should the invoices reach that level.¹⁶ Congress and the IRS need to come up with new sources of revenue, and quickly or the United States will risk losing its status as a safe-heaven for investors. One of the potential sources of additional revenue for

¹⁴ Graetz, *supra*, at 4-6.

¹⁵ USDebtClock.org, <http://www.usdebtclock.org> (last visited Dec. 3, 2013). USDebtClock.org is a non-partisan organization that aims to inform the American public about the growing debt crisis the United States faces. Their information is calculated from the best available sources, including the IRS and the US Department of the Treasury.

¹⁶ Glenn Kessler, The Washington Post, *How Much Did Healthcare.gov Cost?*, The Fact Checker: The Truth Behind The Rhetoric, <http://www.washingtonpost.com/blogs/fact-checker/wp/2013/10/24/how-much-did-healthcare-gov-cost/> (December 2013).

the government is the federal estate tax. The federal estate tax is heavily sighted for reform due to the relatively low administration and enforcement costs to the IRS, coupled with the large number of excluded estates and avoidance techniques that are afforded to estate holders through ATRA. This makes it a prime candidate, as the IRS will be hoping to tap into the additional revenues that are easily there for the taking.

Before we can talk about the potential revenue estate tax reform would bring in, it is crucial to understand just how much revenue IRS generates by administering the estate tax. In FY 2012 the IRS collected a total of \$2.52 trillion in federal receipts from all sources of taxable income.¹⁷ In the same year total receipts attributable to the federal estate tax were calculated to be \$11.5 billion.¹⁸ A simple percentage calculation shows that revenue collected from the estate tax in 2012 under ATRA amounted to 0.45% of all revenues collected by the IRS in 2012. This is a significant departure from the \$29 billion collected in 2008 (around 1% of total IRS revenue), and palpable in comparison to the high of 9.7% of total IRS revenue coming from the estate tax in 1936. In fact, it accounts for even less of the IRS revenues than it did with the estate tax was officially enacted in 1916 (0.8% of all receipts).¹⁹ Clearly, this sharp decrease in easy revenue for the IRS is one of the major driving factors

¹⁷ Nina E. Olson, National Taxpayer Advocate, *2012 Annual National Taxpayer Advocate Report to Congress*, <http://www.irs.gov/uac/Newsroom/National-Taxpayer-Advocate-Delivers-2012-Annual-Report-to-Congress> (2012). These sources include both individual liabilities as well as corporate liabilities.

¹⁸ Urban-Brookings Tax Policy Center, *Estate Tax Returns and Liabilities 2011-2022*, <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3775> (2013).

¹⁹ Joulfaian, *supra*, at 6-1.

behind the argument for the repeal of ATRA and serious reform to the federal estate tax.

Now that we are able to understand of the history of the estate tax, the intentions behind its enactment, the types of estates and assets which are eligible and the amount of revenue that this tax currently brings in for the IRS we can move on to the proposed change in legislation.

II. Proposal

When a governing body wishes to increase tax revenues there are three major ways it can accomplish this goal. The first method is simply to implement a new tax that brings in fresh revenue from sources that are often being taxed for the first time. These can be in the form of excise taxes [on things like cigarettes, tobacco products and alcohol] or as innovative as “congestion charges” that have been enacted in the United Kingdom to discourage motorists from entering the city of London during peak traffic hours.²⁰ The possibilities of governments enacting new taxes are virtually limitless. However enacting new taxes comes with the added complication of needing to gain public support and agency support as well as having the legislation be adopted. There are also the problems of increased costs in order to administer the tax and enforce it. Not to mention the legal challenges that may arise to the constitutionality of a new tax, and the costs associated with litigating any such legal conflicts.

²⁰ Transport for London, Congestion Charges: How It Works, <http://www.tfl.gov.uk/roadusers/congestioncharging/6718.aspx> (December 2013). London’s congestion charges were initiated in February 2003, and is the largest system of its kind on the planet. This system uses London’s extensive network of CCTV cameras to track the license plates of motorists entering the city during times they seek to ease congestion. The driver has the opportunity to prepay this tax, or be billed later.

The remaining two ways to increase tax receipts then require using existing tax regulations that are already in place by either: broadening the base of eligible taxpayers, increasing the marginal rates on existing taxpayers, or some combination of these two methods. However, these methods are often at odds with one another and generally represent two different ends of the political and social spectrum. Rate increases are usually directed at the wealthier end of the eligible taxpayers, which opponents of rate increases argue unfairly targets wealthy taxpayers and disproportionately increases their burden. Those who support using tax rate increases argue that these types of progressive taxes are specifically conditioned to affect those who are in a better position to pay, and are therefore appropriate from a fairness perspective. Proponents of broadening the base say that it increases equality by making sure that all eligible taxpayers are contributing something, no matter how small the amount. On the other hand, opponents of base broadening argue that it burdens taxpayers who may be disproportionately able to pay, and therefore is improper from a fairness perspective. Clearly the major clashing ideologies in tax policy are those of fairness versus equality.

The federal estate tax then is viewed as being one of the United State's most progressive taxes. It is heavily skewed towards the wealthiest individuals and assumes that they are in the best position to pay due to their financial circumstances. Because ATRA has afforded such a high threshold for the value of exempted estates [\$5.25 million], many opponents of the estate tax in its current form argue that both the exemption level needs to decrease and the maximum taxable rate should

increase.²¹ This then would be an example of both base broadening and rate increases.

For my proposal I would first have the maximum exemption amount for an estate be lowered back to \$1 million. This alone would increase both the number of eligible estates and the amount of available receipts drastically, bringing in equal to or greater than the collection of \$29 billion by the IRS in 2008. This would also require lowering the lifetime gift rates to \$1 million [down from its current \$5.25 lifetime max] while still leaving the \$14,000 yearly gift rate intact.²² I would also leave the spousal deduction intact, allowing the donor to transfer the full amount of the estate to his or her spouse without triggering any federal tax liability. The stepped up basis and other statutory exemptions for family-owned small business also would still remain intact. These exemptions have been very carefully thought out and have been enacted through years of trial and error and I believe it would be counter-productive to eliminate them. However, the most significant change I am

²¹ N.B. I want to clarify that personally I do not support the estate tax in any form. I believe it is an unfair burden placed upon the wealthy who have already paid their fair share of taxes on these assets. I believe double-taxation creates enormous economic waste and is something that federal and state governments should seek to avoid at all costs. Though I disagree with the tax, I do understand the reality that my views generally may no longer be supported by a majority of the American public. With movements like Occupy Wall Street, younger generations becoming more and more populist in their political and social ideologies, the staggering rate at which the wealth gap is growing in the United States, and the relentless war on the wealthy currently being waged by President Obama, the Senate, and his supporters means the days of high privilege for the rich are numbered. This paper assumes the estate tax is here to stay and considers a proposal to take the estate tax back to its roots of social welfare, rather than making it into an increase of revenue for the federal government. The proposal seeks to strike a balance between autonomy of the estate holder and the valid concerns of wealth inequality and social welfare.

²² Allowing the lifetime gift rate to remain at \$5.25 million would render the reduction in exempted estates to \$1 million worthless. Taxpayers would be able to give away \$5.25 million without and tax consequences and therefore would be able to significantly reduce their estates, even to the point where they would be under the \$1 million exemption and thereby not have any federal estate tax liability.

proposing would be to completely eliminate the federal estate tax's charitable deduction exemption.

I am in no way trying to hurt charitable organizations or the causes they support. In fact I am trying to help them achieve their goals on a scale they have never even hoped for. I believe that often times charitable organizations are in better positions to bring about social goods better than the government can, and therefore should be fully supported by society. Instead of just allowing for an unlimited deductible amount, my proposal would call for a series of percentage threshold "steps" in the amount of the taxable estate that would be donated to charity. Once an estate holder chooses the which percentage threshold amount of the estate they wish to donate to charity, the remaining estate would then be subjected to a corresponding federal estate tax at a decreasing rate. The mechanism for this would work in the following way: the higher the percentage of the estate that is donated to charitable organizations, the lower the federal tax rate on the remaining estate would be [lowering in steps until the federal estate tax liability would be zero]. The remaining estate would then be able to be transferred as the donor sees fit without incurring any federal tax liability.

For simplicity in both administrative and compliance costs, the rates for both of these mechanisms would be set in firm percentage thresholds that the donor must prove were met by their charitable donations. If the donor does not meet the percentage threshold exactly, or a donation is made to an organization that is proven to not qualify as charitable then the estate must either donate more money to reach the threshold, or be bumped into the lower donation bracket and accrue an

increased federal estate tax liability. Estates above the \$1 million exemption would still be required to file with the IRS, and then would be able to attach receipts from the charitable organizations they donated to.

As previously stated, the first \$1 million of the estate would be exempted from any federal tax liability and receive a tax credit, identical in the way estates under \$5.25 million do now. Any amount over that \$1 million exemption would then be subject to my proposal. For example: if an individual had an estate worth \$2 million and donated 20% of the estate to charity (\$200,000) the remaining \$800,000 would be taxable under the estate tax at a rate of 22% or a \$176,000 tax liability for the estate. The remaining \$624,000 could then be distributed as the donor saw fit, and would not accrue any additional federal estate tax liability. Again it is also important to remember that under this proposal, the first \$1 million of the estate would be excluded from any tax liability. So of the \$2 million dollar estate \$1.624 million would be able to be given tax-free to whomever the donor wishes. A table of proposed rates is listed below in Figure 1.

Figure 1: Proposed Federal Estate Tax Rates²³

Value of Estate	0% of taxable estate donated to charity	10% of taxable estate donated to charity	20% of taxable estate donated to charity	30% of taxable estate donated to charity	35% or > of taxable estate donated to charity
Less than or equal to \$1 million	No tax liability	No tax liability	No tax liability	No tax liability	No tax liability
Greater than \$1 million	Estate value >\$1 million fully taxable at 48%	Remaining Estate value >\$1 million taxed at 35%	Remaining estate value >\$1 million taxed at 22%	Remaining estate value >\$1 million taxed at 8%	Remaining estate value >\$1 million no tax liability

The same rules that are in place currently for the types of charitable donations that are permitted will still apply. These types of organizations are listed and categorized under 26 U.S.C. §501(c).²⁴ Any estate over worth over \$1 million would require that the donor file the estate with the IRS. In order to be eligible for preferential tax rates afforded through charitable donations, the estate would need to show proof of donation through receipts provided by the charity for the amount donation received. It is also essential that the estate meet the minimum percentage requirements for the desired tax bracket, if this does not happen then they will be bumped to the lower percentage donation with a corresponding higher tax rate on the remaining estate. The estate would be permitted to donate the money to one or multiple charities, however should the IRS challenge the status of one of the

²³ Note that these proposed rates are not absolute and are subject to change. These are rough estimates that seek to incentivize increased donations to charity by reducing the amount of federal tax liability.

²⁴ These organizations described include both public charities and private foundations as described by the Internal Revenue Code.

charitable organizations receiving money the burden would fall on the estate and on the charitable organization to prove that the organization is in fact a charitable one.

While we have already seen an example of an estate that is relatively small, for purposes of comparison, it would also be useful to look at how this proposed change would affect larger estates. Let's suppose we have an estate that is valued at \$10 million that is unable to take a spousal deduction and does not qualify for the family owned business exemption. Only \$9 million of this estate is going to be subjected to the federal estate tax. If the donor chooses not to contribute any of his estate to charity, he will be left with a tax liability of \$4.32 million. If he chooses to contribute 10% of his estate to charity then after the \$900,000 donation to a charity of his choice he will be left with a \$2.84 million dollar tax liability. Should he choose to contribute 20% of his estate to charity, he will then be left with a \$1.8 million dollar tax liability. A 30% donation of the estate to charity would leave a \$500,000 tax liability. And finally a 35% or greater donation to charity would leave the donor with a \$0 tax liability. Table 2 illustrates the breakdown of this estate holder's tax liability.

TABLE 2: \$10 Million Estate Federal Estate Tax Example

\$9 Million Taxable	0% To charity	10% to Charity	20% to Charity	30% to Charity	35% to Charity
Total To Charity	\$0	\$0.9 Million	\$1.8 Million	\$2.7 Million	\$3.15 Million
Total Tax Liability	\$4.32 Million	\$2.84 Million	\$1.58 Million	\$0.5 Million	\$0 [No tax liability]
Remaining Estate	\$4.68 Million	\$5.26 Million	\$5.62 Million	\$5.8 Million	\$5.85 Million
Total Distributable Estate²⁵	\$5.68 Million	\$6.26 Million	\$6.62 Million	\$6.8 Million	\$6.85 Million

Clearly this proposal is meant to both heavily favor and encourage charitable contributions by an estate. In the \$10 Million estate example, the difference in the amount of tax owed between the estate making the 35% contribution to charity and making a 0% contribution leaves the estate holder with an additional \$1.17 million in their pocket to distribute without any further federal tax liability. It would be highly unlikely in any scenario for an estate to opt to donate to pay 0% to charity and be hit with the full 48% tax on the amount of the estate over \$1 million. It is also unlikely that an estate will opt for either the 10%, 20%, or 30% to charity donation and will almost always go for the 35% donation. These lower percentage thresholds are there in the event the estate does not strictly comply with the percentage cutoffs and is then set into a lower donation bracket with a higher remaining estate tax liability.

While the proposed strict requirements on the percentage donation amounts may seem harsh or burdensome to the estates, it is also important to understand

²⁵ This amount reflects the \$1 million exempted amount added back to give a grand total of the amount of the estate that can be distributed

that they are being given quite a bit of latitude in both terms of the maximum amount they have to donate and to which organizations they can donate to. These requirements are then necessary to make sure that the donations are being made fairly and in good faith.

Now that we have explored what the proposed legislation would look like, the next step is to find proper support for this proposal and see whether or not it is a viable alternative.

III. Support for Proposal

a) Charitable Contributions by the Wealthy

The United States has long supported charitable contributions by its taxpayers. In fact the federal state tax has been subject to charitable bequest deductions since 1918. In 2004 alone, charitable bequests from estates totaled \$18.47 billion (or 8% of all charitable giving in that year).²⁶ This is a significant amount of money going to charitable organizations, and it is important to make sure these funds continue flowing to these organizations. A disruption in the amount of money donated to charitable organizations through estates would deal a significant blow to many of these organizations and prevent them from effectively carrying out their mission.

While deductions for charitable contributions are commonplace, the unlimited charitable deduction of the estate is a unique nuance in tax legislation. It also has the distinction of having never really been fully understood or been completely explained. It is in sharp contrast to the personal income tax charitable deduction

²⁶ Miranda Perry Fleishcer, New York University School of Law, *Charitable Contributions in an Ideal Estate Tax*, 60 Tax L. Rev. 263 (2007). (This estimate comes from the Ctr. On Philanthropy at Indiana University and includes both bequests of estates filing returns and estates that were exempted from the filing threshold)

limitations that factor in the type of donated property, the taxpayers adjusted gross income (AGI), and the type of charitable organization that is receiving the property. In a very basic example, a taxpayer who wishes to make a cash donation to a recognized charitable organization would be limited to a deduction of up to 50% of their AGI for that year in the case of a public charity or 30% of their AGI for certain private foundations.²⁷

Though a complete explanation for the unlimited estate charitable deduction has never been given, most legal scholars are in agreement that the legislative purpose behind the estate tax is a driving force in this allowance for an unlimited charitable donation deduction.²⁸ The rationale is that the estate tax may have first been enacted to help the government raise revenues, but in its permanent and more modern form it now serves a purpose of wealth redistribution and economic justice.²⁹ That is, the tax seeks to accomplish a reduction in dynastic wealth transfers [keeping large amounts of wealth in the hands of a small number of powerful and influential families] and to make sure that money is redistributed among a larger group of people to achieve a greater social good. The fact that

²⁷ 26 USC §170 (Private operating foundations are permitted to have the full 50% deduction, however for general private foundations there are a number of factors that must be considered in determining whether the 30% or 50% limitation will apply. These include: if the PF distributes the contributions to public charities and private operating foundations within 2.5 months following the receipt, and private foundations that pool their contributions in a common fund and make payment of those contributions to public charities. Internal Revenue Service, *Charitable Contribution Deductions*, <http://www.irs.gov/Charities-%26-Non-Profits/Charitable-Organizations/Charitable-Contribution-Deductions> (Nov. 2013).

²⁸ See Fleishcer, *supra*, 264; Sarah Waldeck, *An Appeal to Charity: Using Philanthropy to Revitalize the Estate Tax*, 24 Va. Tax Rev. 667, 669 (2005).

²⁹ Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The role of Distributive Justice*, Illinois Law and Economics Research Paper Series Research Paper No. LE09-006 (2012).

receipts from this tax only comprise a very small percentage of total IRS receipts is further evidence that this tax is clearly about more than just revenue generation. This view of the estate tax being more about social welfare than revenue collection is shared by some of the wealthiest individuals in the world such as Bill Gates, Sr., George Soros, and Warren Buffett. These supporters fear a complete repeal of the federal estate tax will no longer give wealthy families tax incentive to donate large portions of their estates to charity and as a result charitable contributions will suffer.³⁰

Their concerns aren't without merit. Most notably supporters of this position will point to the decline in charitable bequests made in the wake of the Economic Recovery Tax Act of 1981. Historical data shows that estate filers making charitable bequests dropped from 22% in 1976 to 17% in 1982.³¹ Estimates from several different independent sources as well as the Congressional Budget Office all indicate that the increased estate exemption and decreased corresponding rate will increase the costs of charitable giving for wealthy estates, thereby discouraging them from making large donations to charity. This would result in more of an estate's wealth remaining concentrated in the hands of a smaller number of individuals.³²

³⁰ See Kristine Knaplund, *Charity for the "Death Tax": The Impact of Legislation on Charitable Bequests*, 45 Gonz. L. Rev. 713, 715 (2010).

³¹ *Id.* at 714 (This data came from an IRS report prepared for the Federal Taxation of Inheritance and Wealth Transfers).

³² Jon M. Bajiha, William Gale, Joel Slemrod, Charitable Bequests and Taxes on Inheritance and Estates: Aggregate Evidence from across States and Time, National Bureau of Economic Research Working Paper 9661, <http://www.nber.org/papers/w9661> (April 2003; see also Jon M. Bajiha, William Gale, Effects of Estate Tax Reform on Charitable Giving, Tax Notes (June 2003).

While these are valid concerns, the federal tax rates are not the only things a potential donor will consider in deciding whether or not to make a charitable contribution. Generally there are six factors which have significant influence on an individual's charitable contributions: size of the donor's family, the financial status of the donor and family members, the donor's philanthropic intent, the tax laws, and the current state of the economy.³³ Gabbard and Acosta also premise their paper on the following assumption, which I believe is both relevant and extremely supportive of my proposal. The assumption is that "the current favorable transfer tax laws will enable individuals to secure their heirs' inheritance at a lesser cost than ever before and thus, individuals will have increased assets to devote towards charitable purposes." ³⁴ While my proposal may reach more estates than what the current tax code does, I believe my contribution requirements are significantly less of a burden than a traditional estate tax. This, in theory should allow them to have an easier time transferring their estate to their heirs from a financial standpoint, and in turn will lead to more money being available for them to donate to charity.

A 2010 study on philanthropy found that the top three motivating factors for charitable giving amongst high net worth individuals (HNWI) were: 1) being moved at how their gift can make a difference, 2) feeling financially secure, and 3) seeing the donee as being an efficient organization.³⁵ ³⁶ While factors 1 and 3 may not be

³³ Renee M. Gabbard, Megan Acosta, *The Impact of the 2010 Tax Relief Act on Charitable Giving*, 23 TXNEXEMPT 36, 37 (2011).

³⁴ *Id.* at 38.

³⁵ The term "high net worth individual" is widely used throughout the financial services industry and does not have an exact meaning that is readily defined. Each financial institution has their own set of criteria in determining who qualifies as a high net worth individual in their eyes, however the general consensus is that a HNWI is an individual with

helpful in our analysis, the second factor certainly is. If a HNWI donor is able have a great sense of financially security in terms of the amount of their estate that will be able to be transferred to their heirs and descendants, then this study seems to suggest that the HNWI will be more likely to make a charitable bequest from their estate. It is also important to note that HNWI are more likely to donate larger amounts of money to charitable organizations in the form of bequests rather than through the traditional gifts of income. Thus they often under-utilize the deductions for donations of income afforded under IRC §170.³⁷ In his paper analyzing charitable giving in life versus death Mr. Joulfaian states, “this pattern [of increased donations in bequests] suggests that the very wealthy are unwilling to part with their wealth during life, but become very generous and philanthropic at death.”³⁸ He also notes that the opposite trend is true for less wealthy individuals, their giving habits tend to be higher in life than in death since they are afforded a larger income tax incentive under §170 than the very wealthy are.³⁹ With this information in mind, it is clear of the importance of incentivizing and encouraging very wealthy donors to continue bequeathing large amounts of their estates to charitable organizations.

more than \$1 million in liquid assets. See Andrew Kalusner, Forbes Magazine, *Characteristics of High Net Worth Individuals*, <http://www.forbes.com/sites/advisor/2013/05/09/characteristics-of-high-net-worth-clients/> (2013).

³⁶ *Id.* at 36 quoting The Center on Philanthropy at Indiana University, “The 2010 Study of High Net Worth Philanthropy: Issues Driving Charitable Activities amongst Affluent Households (Nov. 2010), available at http://www.philanthropy.iupi.edu/research.docs.2010BAML_HighNetWorthPhilanthropy.pdf

³⁷ David Joulfaian, Office of Tax Analysis US Department of the Treasury, Charitable Giving in Life and Death (July 2000); see also David Joulfaian, On Estate Tax Repeal and Charitable Bequests, Tax Notes June 8, 2009, 1221 (2009).

³⁸ *Id.* at 10.

³⁹ *Id.* at 10-12.

b) Public Choice and Subsidy Theory

One of the leading arguments by economists for the continued support of income and estate tax deductions for charitable donations is that these donations reflect public choice more accurately than direct government subsidies do. The theory behind this argument is that private individuals will donate to the charities they deem to be serving the greatest social need or that are most supportive of their personal and philanthropic views.⁴⁰ The benefit of this is that only those organizations whose causes society deems relevant or socially desirable will receive funding. Rather than having federal bureaucracies apportion funds to organizations they support and at their own pace, these funds will be received more rapidly and will avoid problems with any political red tape. This theory also supports the idea of giving much more autonomy to the estate holder, as they will have the ability to decide which charitable organizations they wish to support.

In conjunction with this theory is another argument made by economists that stresses donations to charitable organizations go far beyond providing a source of utility to just the donor. By their nature, charitable contributions often will confer benefits onto other members of society who may have contributed little or nothing towards the charity themselves. This would come through donations to organizations that provide funding for museums, operas, public parks and gardens, etc. Often times these are open to the public and can freely be enjoyed, despite an

⁴⁰ Fleischer, *Theorizing the Role of Distributive Justice*, *supra* at 12-13.

individual not having contributed anything to the sponsoring charitable organization.⁴¹ The combination of these two theories provides powerful support for why the federal estate tax should be more favored towards having money contributed to nonprofit organizations rather than collected by the IRS.

c) Supporting Savings and Other Economically Desirable Outcomes

The United States tax code often seeks to encourage and incentivize certain behaviors that the federal government deems to be desirable. Numerous behaviors such as home ownership, retirement savings, charitable giving, and even marriage are all encouraged by the current tax code.⁴² The IRS accomplishes this by giving incentives to taxpayers who engage in these types of activities. These incentives come in the form of itemized deductions, tax credits, deferred taxes, or preferential tax rates and income brackets [in the case of the married joint filers]⁴³.

Increased donations to charitable organizations are socially desirable outcomes in the eyes of the federal government. That is why there currently stands a charitable deduction for the federal income tax under IRC §170 and why there exists an unlimited charitable deduction in the cases of estates. With this proposal, we are simply attempting to enhance this previously identified socially desirable

⁴¹ See Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, at 22, in Susan Rose-Ackerman, *The Economics of Nonprofit Institutions* 21 (1986).

⁴² Waldeck, *supra* at 2

⁴³ The marriage bonus is not always possible, but with the passage of the 2001 Tax Act is becoming more and more accessible to couples filing jointly. The 2001 Act sought to increase the availability of the marriage bonus by increasing the amount of deductions allowed and by increasing the maximum joint income allowed in the 10% and 15% tax brackets. See Tax Policy Center, *Taxation and the Family: What are the Marriage Penalties and Bonuses?*, <http://www.taxpolicycenter.org/briefing-book/key-elements/family/marriage-penalties.cfm> (April 2008).

outcome by increasing the amount of donations given directly to charitable organizations. As previously discussed, currently the receipts collected by the IRS from the estate tax are less than 1% of all total receipts collected. While this amount still translates into billions of dollars in additional revenue each year, the federal government could make up this difference by cutting back on the amounts of money given to charitable organizations through federal grants or by increasing or enacting new taxes to bring in additional revenue.

Increases in charitable giving should also be more aggressively encouraged due to the myriad of economic problems the federal government is grappling with. The recent government shutdown and ballooning federal debt is starting to take its toll on the social welfare programs that many individuals depend on. Total federal government spending on these programs has skyrocketed in the past few years, topping \$700 billion in 2010. This number represents a 33% increase over the amount of federal spending on these programs in 2008, which rested around \$525 billion.⁴⁴

While increased charitable contributions from estates won't eliminate the staggering amount of money these welfare programs are draining from the federal budget, they may help alleviate some of the strain the federal government is facing. Eliminating Medicaid costs from the 2010 spending brings the total down to \$425

⁴⁴ Peter Ferrara, *Forbes Magazine*, *America's Ever Expanding Welfare Empire*, <http://www.forbes.com/sites/peterferrara/2011/04/22/americas-ever-expanding-welfare-empire/> (April 2011). These figures come from the Congressional Budget Office and represent a compilation of spending for 185 federal welfare programs that are currently in place. This also includes Medicaid expenses.

billion.⁴⁵ If my proposal was enacted, it is safe to assume that at least \$29 billion from estates would be available to be donated to charitable organizations.⁴⁶ That works out to 6% of total spending on federal welfare programs. Compared to the 1% of total receipts this tax generates, it would seem that money would create more social welfare as charitable donations rather than as government revenue.

Finally, my proposal also has the possibility of helping to increase savings among wealthy individuals. The current tax code is supportive of individuals saving money. This is why there are exemptions like IRC §401(k), which allows an individual to contribute to a retirement account and defer the tax payments until later in life.⁴⁷ By offering more favorable rates to large estates this will encourage them to hold on to their money longer, rather than spending it now. Which, for our purposes would be a good thing, as it would mean this more money would be contributed to the charitable organizations rather than being spent on something that may have no impact on charity at all.

From a standpoint of support for the proposal, it appears that it has the potential to create more public welfare than in its current state. However, it is a novel proposal and therefore subject to many possible questions and criticisms.

⁴⁵ *Id.* Medicaid spending is being excluded due to the passage of the Affordable Care Act and the fact that this act guarantees health care coverage for low-income families, which for the purposes of this paper should be considered a social good and a sunk cost.

⁴⁶ This figure comes from the amount collected in 2008 from the federal estate tax, with estates up to \$2 million exempted, and a 40% maximum rate.

⁴⁷ James R. Repetti, Boston College Law School: Legal Studies Research Paper Series, *The Case for the Estate and Gift Tax*, Research Paper 2000-14 (March 2000).

IV. Counter Arguments

a) Disguised Tax

There are many counter arguments to this proposal and some of them are stronger than others. First and foremost the greatest concern would come from those who do not support the estate tax and would point out that this proposal is merely a disguised form of a more inclusive estate tax. While this may seem true on its surface, this proposal gives the estate owner something that a traditional estate tax doesn't, which is autonomy. In a traditional estate tax the money collected by the IRS is pooled together with other tax revenues and spent according to greatest need of the government. Control of when and where this money is spent rests in the hands of the government and not in the hands of the estate holder. Since the IRS does not keep track of the source of each dollar they spend the money collected from the estate tax could be spent on anything from social welfare programs to weapons for the current war in the Middle East.⁴⁸

I believe that the autonomy component of my proposal is enough of a differentiation between it and the traditional estate tax. The estate holder will have the option of choosing how the money is donated, and to what organizations. This way the estate holder is able to further charitable causes that best mirror the donor's beliefs and values.

⁴⁸ Lily L. Batchelder, New York University School of Law: NYU Center for Law, Economics and Organization, *Estate Tax Reform: Issues and Opinions*, Law and Economics Research Paper Series: Working Paper No. 09-02 (2009).

b) Qualifying Organizations

A second criticism is also related to the autonomy issue. The issue would be what if the organizations the estate holder wishes to donate to support causes that are not socially desirable, or if the estate holder donates to private foundations that are controlled by the estate holder's family? In terms of organizations supporting socially undesirable causes, precedent from the federal tax courts has held that organizations supporting illegal activities or those which are contrary to public policy are not permitted to be designated a charity under §501(c).⁴⁹ If a donor makes a contribution to one of these types of organizations, then the IRS would have the power to void the donation and revoke the tax exemption the estate holder would have otherwise been granted. As previously outlined in my proposal, if the IRS challenges the status of an organization that an estate has donated to it then becomes the burden of the estate and/or the charitable organization to prove the organization should continue to be recognized as a charitable one.

Switching to the second component of this concern, the problem of private foundations being controlled by the family members of the estate is nothing new. In fact, Fleishcer points out in her *Charitable Contributions in an Ideal Estate Tax* paper the problems that arise in allowing estates to have an unlimited donation exemption that extends to private foundations. She argues that if the purpose of this tax is to

⁴⁹ See Internal Revenue Service, *Activities that Are Illegal or Contrary to Public Policy*, <http://www.irs.gov/pub/irs-tege/eotopicj85.pdf> (1985); see also Better Business Bureau v. United States, 326 U.S. 279 (1945); Rev. Rul. 75-384, 1975-2; Bob Jones University v. United States, 693 F. 2d. 147 (4th Cir. 1980); The Church of Scientology v. Commissioner, 83 T.C. No. 25 (1984). These cases all have upheld the doctrine of charitable organizations whose purpose is deemed to be illegal or against public policy will no longer receive tax-exempt status from the federal government. This applies to all types of organizations including universities, churches, hospitals, etc.

break up dynastic wealth, allowing a full deduction for contributions to family run foundations does not accomplish this goal. This is because the family will still wield extremely large economic power, and this power will have significant influence on others.⁵⁰ For example if the family foundation runs a hospital, a large increase in the amount of money donated to the foundation would give the family considerable influence on what projects the hospital undertakes (i.e. moving the hospital out of a certain neighborhood or adding more premium facilities to attract more affluent patients).

While this can be problematic, private foundations are also subject to a much higher level of scrutiny by the IRS than their public charity counterparts. For example, private foundations are required to distribute at least 5% of their annual income or be subjected to a 15% excise tax.⁵¹ Additionally there are requirements regarding transfers and conduct between the foundation and disqualified persons [which for our purposes would include the immediate family members of the estate holder].⁵² Most importantly, however is the provision that any investments made by the private foundation must not jeopardize the carrying out of the organizations purpose for exemption and to make sure those capital expenditures serve to further the organizations exempt purpose.⁵³

While there are very strict guidelines and oversight by the IRS for private foundations, I will concede that allowing donations to private foundations to satisfy

⁵⁰ Fleischer, *Charitable Contributions in an Ideal Estate Tax*, *supra* at 284.

⁵¹ Internal Revenue Manual 7.27.16.1.1 (1999).

⁵² IRC §509(1)(a); 49041(a), (b), (c)

⁵³ *Id.* see Madden v. Commissioner, 74 T.C.M. (CCH) 440 (1997). Held a foundation liable for two payments made that benefitted Mr. Madden directly and a third payment that benefitted the for profit organization owned independently by Mr. Madden.

the proposals charitable donation requirement could prove problematic. I would then suggest a wait and see type approach before enacting any legislation preventing the donations to private foundations to qualify for my proposal. If problems with donations to private foundations begin to arise [i.e estates begin leaving abnormally large sums of money to private foundations controlled by their family members and that money is not being used to further the purpose of the organization] then the IRS should prohibit donations to private foundations from being made. This can easily be done through a revenue ruling or a change in the tax code, and should not be an issue that stops the proposal from being viable.

c) Low Rates

A third criticism is that the bracket in which the estate holder receives a zero estate tax liability owed to the IRS is at significantly lower percentage than if the estate holder makes zero donation to charity and elects to pay the estate tax. While the overwhelming majority of individuals are going to donate the maximum value to charity (35% of the estate rather than pay 45% to the government) it is important to note that this proposed reform is intended to encourage a higher amount of charitable giving among all estates. With this proposal, we want taxpayers to give that 35% of their estate to charitable organizations that will promote social welfare.

d) Charitable Contributions Benefit The Rich & Timing Effects

Many legal scholars argue that deductions for charitable contributions benefit the wealthy more than the poor.⁵⁴ While this is not always the case, it does come up when individuals make large donations to charitable organizations that only provide benefits to more affluent individuals. For example: donations to elite universities, private clubs or organizations, operas, etc. These types of organization may not generate any positive effects on the poor or disadvantaged, and may actually seek to further the economic power wielded by these dynastic families. A powerful example of this would be an estate that donates a large amount of money to a prestigious college, which in turn would give favorable treatment to the applications of the estate holder's grandchildren who apply to the school.⁵⁵

This may pose a problem and may take away from the purpose of the proposal. However as Fleischer points out, the IRS can simply restrict the types of charitable organizations that are permitted for the purposes of my proposal. A simple addition to the regulation that the organizations being donated to must have a purpose that deals with providing services to or alleviating ailments of those with low incomes or other significant disadvantages.

There is also a concern that the enactment of this proposal would substantially alter the timing of charitable contributions made by wealthy individuals. Instead of donating money as it is earned, they may wait until their death to make charitable contributions since they are afforded a greater tax

⁵⁴ See Fleischer, *Theorizing the Charitable Tax Subsidies*, *supra*; Bakija, Gale, *Effects of Estate Tax Reform on Charitable Giving*, *supra*.

⁵⁵ See Gale, Slemrod, *Rethinking the Estate and Gift Tax*, *supra* at 46.

incentive in estate donation then they are in income donation. Knaplund discusses this issue and notes that wealthy individuals are already more likely to donate to charity in death than in life.⁵⁶

V. Conclusion

There is never going to be a consensus as to what is the ideal way to administer an estate tax. While many of the developed nations have been abolishing their inheritance taxes throughout the 20th and 21st centuries, the United States has held firm. This tax represents more than just a source of revenue for the federal government. It represents the ongoing battle between the 1% of wealthiest American and the other 99%. It is truly remarkable how a tax that affects so few Americans and generates so little government revenue has gained so much public and political attention over the years.

My proposal, like so many others, seeks to reform this tax into something that is fair across the board. Fair for the wealthiest individuals, and for the poorest of the poor. I believe that giving wealthy individuals the option of donating significant portions of their estates to charitable organizations and escaping any federal tax is the best solution to this problem. While the IRS may lose out on 1% of the receipts it collects, the social and economic benefits it provides far outweigh the costs. Most notably, wealthy individuals will be far happier about being forced to donate to charitable organizations than they will be about having to pay money to the federal government. After all, no one wants to be caught complaining about donating to charity.

⁵⁶ See Knaplund, *Charity for the "Death Tax": The Impact of Legislation on Charitable Bequests*, at 725.

This is not to say my proposal is not without its valid criticisms or faults. As I pointed out, there are a number of issues that may arise from this proposal and the IRS is going to have to find a way to make up for the differences in revenues lost [no matter how small that may be]. Chances are this will come in the form of new or added taxes, but the exact way they will go about this is beyond the scope and intent of this paper. I believe that from the evidence presented my proposal will work, and therefore should be considered as an alternative to the traditional federal estate tax.